

Internal Revenue Service
memorandum

date: July 1, 2002

to: Larry Scharf, Team Manager, Reading, PA
Attn: Revenue Agent Don Palm

from: James C. Fee, Jr. POSTF-119950-02
Associate Area Counsel (LMSB) JEBecker, Jr.

subject: Nondocketed Case Advice
[REDACTED] Inc.
Component Depreciation under I.R.C. §168

This memorandum responds to your request for advice, dated April 8, 2002, in connection with the taxpayer's assertion that Treasury Regulation §1.168-6 only applies to ACRS assets. This memorandum should not be cited as precedent.

This writing may contain privileged information. Any unauthorized disclosure of this writing may have an adverse effect on privileges, such as the attorney client privilege. If disclosure becomes necessary, please contact this office for our views.

ISSUE

1. Is Treasury Regulation §1.168-6 valid for MACRS assets?

FACTS

The taxpayer remodels various stores by removing parts of the existing buildings such as walls, etc. The removed walls and other parts of the buildings were component parts of the original buildings and not separate assets. The taxpayer did not treat such components as separate assets on its books. The taxpayer computed the cost of a removed component through an allocation of the entire cost of the original building, reduced that cost by the applicable depreciation to arrive at a book value for that component, and then deducted that amount as a loss on Form 4797 (Sale Or Exchange of Assets Used in a Trade or Business), showing

the sales price as \$-0-. The taxpayer claims that such treatment is justified by the fact that when Code Section 168 was modified in 1987 to become MACRS instead of ACRS, Treasury Regulation §1.168-6 was deleted and therefore does not apply to the MACRS assets in his case.

DISCUSSION

At the outset, it must be noted that the Regulations under §168 at issue were Proposed Regulations for ACRS. Prior to the enactment of ACRS, a taxpayer could use the component method of depreciation for real property. Under the component method of depreciation, the taxpayer would allocate the cost of a building to its structural components (as defined in § 1.48-1(e)(2)) and then assign a separate useful life to each of these components. Each of these structural components is depreciated by the taxpayer as a separate item of property. See S. Rep. No. 97-144, 1981-2 C.B. 412, 422.

The enactment of ACRS, however, eliminated the component method of depreciation. ACRS § 168(f)(1). See S. Rep. No. 97-144, 1981-2 C.B. at 428; see also Hospital Corporation of America v. Commissioner, 109 T.C. 21, 45 (1997) ("HCA"). Accordingly, each structural component of a building is no longer permitted to be depreciated as a separate item of property under ACRS.

Consequently, a retirement of a structural component of a building subject to ACRS is not a disposition. The Joint Committee on Taxation Staff, in its explanation relating to gain on disposition and recapture of depreciable property subject to ACRS, stated that "Congress did not intend a retirement of a structural component of the building to be a disposition requiring recognition of gain or loss. Thus, if the roof wears out, no loss is recognized upon retirement and the unadjusted basis of the building is not reduced (i.e., cost recovery continues over the remaining recovery period). If the roof is replaced, the unadjusted basis of the new roof is recovered over a new recovery period beginning in the month it is placed in service." Joint Committee on Taxation Staff, General Explanation of the Economic Recovery Act of 1981, 97th Cong., 1st Sess. (1981). This rule is the one stated in Prop. Reg. §§ 1.168-2(1)(1) and 1.168-6(b).

Prop. Reg. §1.168-2(1)(1), which defines "Disposition", states that "A disposition also does not include the retirement of a structural component of 15-year real property." Prop. Reg. §1.168-2(e) does not permit the component method of depreciation.

It states "In general, the unadjusted basis of structural components (as defined in §1.48-1(e)(2)) of a building must be recovered as a whole. Thus, the same recovery period and method must be used for all structural components, and such components must be recovered as constituent parts of the building of which they are a part." The definition of structural components under §1.48-1(e)(2) includes such parts of buildings as walls, partitions, floors, ceilings, as well as permanent coverings therefor such as paneling or tiling; windows and doors; all components (whether in, on, or adjacent to the building) of a central air conditioning or heating system, including motors, compressors, pipes and ducts; plumbing and plumbing fixtures, such as sinks and bathtubs, electric wiring and lighting fixtures; chimneys; stairs, escalators, and elevators, including all components thereof; sprinkler systems; fire escapes; and other components relating to the operation or maintenance of the building.

Prop. Reg. §1.168-6, which concerns gain or loss on dispositions, sets forth at (b)(1): "See §1.168-2(l)(1) for the definition of "disposition," which excludes the retirement of a structural component of 15-year real property. Thus, no loss shall be recognized on such retirement, and the unadjusted basis of the property under §1.168-2(d) shall not be reduced. For example, if a taxpayer replaces the roof on 15-year real property, no loss is recognized upon the retirement of the replaced roof, and the unadjusted basis of the property continues to be recovered over the remaining period."

This rule did not change with the enactment of MACRS. MACRS continues the prohibition against the use of the component method of depreciation. S. Rept. No. 99-313, 1986-3 (Vol. 3) 1, 105. See also HCA, 109 T.C. at 46-47. Accordingly, a structural component of a building is not permitted to be depreciated as a separate item of property under MACRS and, as a consequence, a retirement of a structural component of a building subject to MACRS is not a disposition.

It is noted that the Tax Court has concluded that items in a building that qualify as tangible personal property under the investment tax credit rules in effect prior to 1981 may be separately depreciated under MACRS and ACRS as Section 1245 property. HCA. The court also noted that structural components of a building are specifically excluded from the definition of tangible personal property by the investment tax credit regulations.

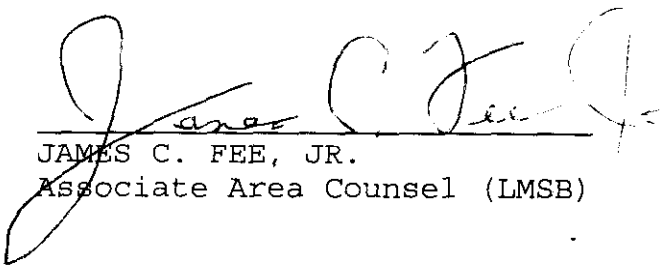
CONCLUSION

The following conclusion is based solely upon the facts which you presented to us.

The taxpayer's position has no merit because it in effect results in component depreciation, which is not permitted under MACRS. The replacement of structural components does not permit the recomputation of the basis of the building and subsequent loss treatment for the structural components which the taxpayer employed on its tax return.

If you have any questions concerning this memorandum, please call Attorney John E. Becker, Jr. at 215-597-3491.

Our advice is subject to the Office of Chief Counsel's ten day post-review procedures. If the Office of Chief Counsel alters or revises our advice they will contact us within ten working days from their receipt of our advice.



JAMES C. FEE, JR.
Associate Area Counsel (LMSB)

cc: Associate Chief Counsel (Procedure and Administration)
Technical Services Section